

USAID Economic Growth Officers Training Program
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1. Trade and Investment



Introduction

Stephen Lewarne, VP, The Services Group (TSG)



Why Bother With Trade?

- **Because it is a major world economic force.....**

- Grown in absolute terms: 22-fold since 1948
- Grown in relative terms: world output rose only 7-fold during the same period
- Growth is accelerating: world trade/GDP ratio grew from 8% in 1950 to 29.5% in 2000

- **....benefiting Developing Countries**

- DC share of world merchandise exports rose from 17% in 1990 to 30% in 2000
- Growth in LDC merchandise exports in last two years exceeded growth in world exports

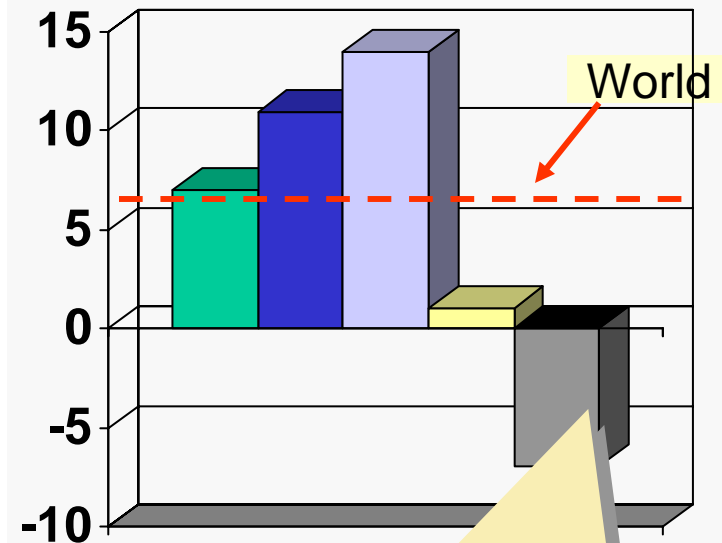
But There are Important Differences

Developing Countries

- **Ten** countries account for 64% of all DC exports
- **China and Asian NDCs** account for 45% of total

China	\$249.3 B (13.4%)
S Korea	\$172.3 B (9.3%)
Mexico	\$166.4 B (8.9%)
Taiwan	\$148.3 B (8%)
Saudi Arabia	\$84.1 B (4.5%)
Singapore	\$78.9B (4.2%)
Thailand	\$69.1B (3.7%)
Indonesia	\$62.1 B, (3.3%)
Brazil	\$55.1B, (3.0%)

LDC Merchandise Exports by Group
(Annual Average % Change)



LDCs with civil strife are those countries that experienced political or other problems such as Afghanistan. As a group, their exports dropped by an average annual 7% over the decade.

■ LDCs with Civil Strife

Link Between Trade and Growth

■ Trade increases growth

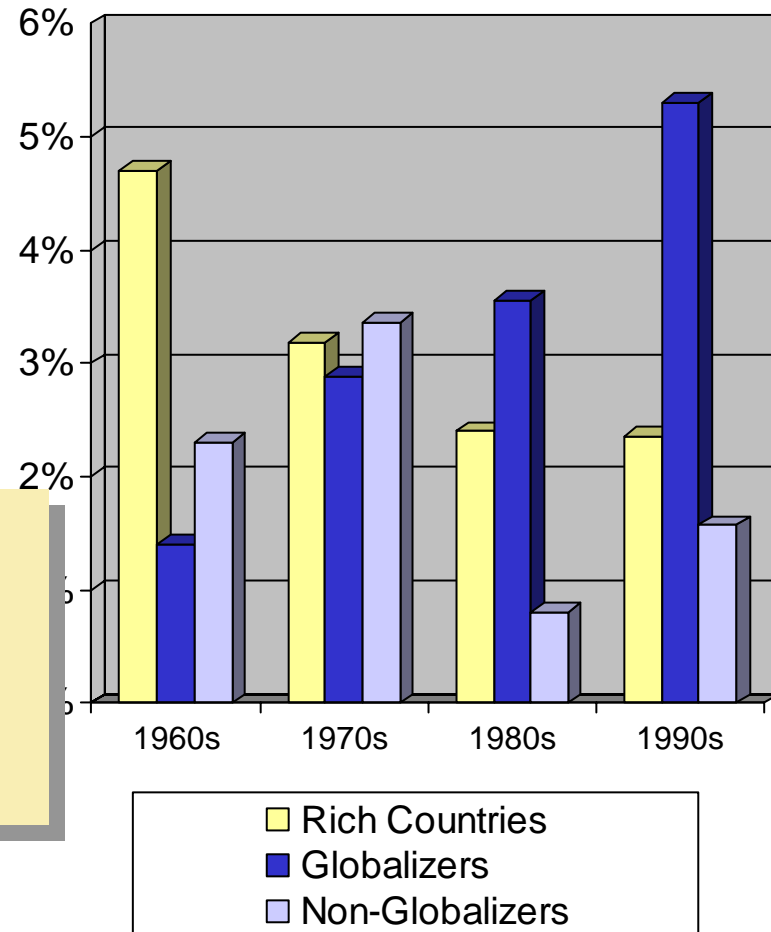
- An increase in trade as a share of GDP of 20% increases growth by 0.5%-1% per year
- In the 1990s, "globalizers" have grown 5.3% per capita, compared to -0.8% for "non-globalizers"

■ Main eff

- Aligns r
compara
- Raises
competit
- Ties a country into global production networks

Developing countries which have brought down the absolute level of their tariff rates over the 1990's versus those that that did not have a an absolute decline.

Real Per Capita GDP Growth



Source: Dollar & Kraay, World Bank

Trade and Poverty Alleviation

■ Trade is good for the poor

- Open economies grow faster, and faster growth is closely linked to income growth of the poor
- Empirically, increased trade lowers poverty: 1% rise in GDP raises per capita income of the poor by ½ to 2%

■ But...

- There are short-run adjustment costs
- Impacts are uneven—losers may not be gainers; there are gender differences
- Complementary policies & initiatives are needed



Some Objections to Trade

- **Developed country concerns**

- Trade leads to “de-industrialization”
- Trade displaces workers and lowers average wages
- Trade/FDI encourage sub-standard labor conditions and sweatshop wages

- **Developing country concerns**

- Trade widens income inequality
- WTO exists to protect industrial country interests
- Globalization undermines sovereignty
- Local industries lose out



Some Objections to

•Jobs are created in new industries, mainly export-oriented

■ Developed country concerns

- Trade leads to “de-industrialization”
- Trade displaces workers and lowers average wages
- Trade/FDI encourages poor working conditions and

•New jobs tend to be higher-paying; lost jobs lower-paying

■ Developing countries

- Trade widens income inequality
- WTO exists to protect developed country interests
- Globalization undermines local industries
- Local industries lose jobs to imports

•80% of WTO members are developing countries

is far
aining

•Not true: growth has lowered income inequality in most developing countries

than domestic industry



Trade Liberalization

- **Trade liberalization has multiple, sometimes offsetting, effects**
 - **Consumers**—greater variety of lower-priced goods
 - **Producers**—better access to lower cost inputs, technology versus greater competition
 - **Fiscal revenues**—reduction in trade taxes versus income from new industries, growth
 - **Employment**—loss of import-competing jobs versus new employment in new industries; impact on the poorest groups



Today's Agenda

- Some basic concepts
- A game to illustrate comparative advantage
- International trade arrangements
- Building trade and investment capacity



USAID Economic Growth Officers Training Program
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1. Basic Concepts—Trade Theory

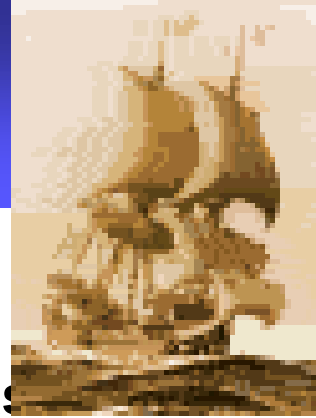


Presentation Outline

- Mercantilism
- Absolute advantage
- Comparative advantage
- Other trade theories



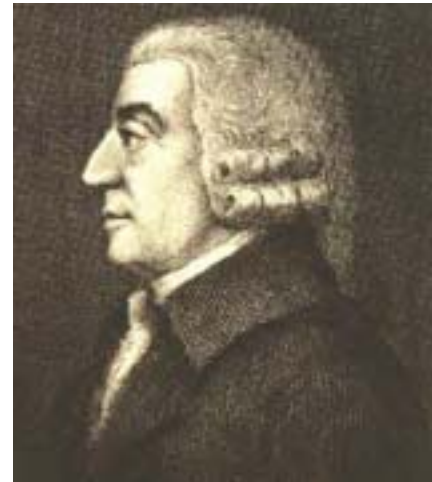
Mercantilism



- **Popular in the 16th century**
- **A nation's wealth depends on accumulated treasure**
- **It's in a nation's best interest to have a trade surplus**
 - Maximize exports through subsidies
 - Minimize imports through tariffs and quotas
- **Zero-sum game: one country can gain only at the expense of another**
- **Mercantilism declined as an explanation of trade due to Hume's specie-flow mechanism argument**
 - In the long-run the accumulation of gold (specie) will raise prices in the accumulating country making the exports of that country relatively less attractive to foreign buyers and imports relatively more attractive to domestic residents—since foreign prices are relatively lower.
- **Neo-mercantilism is still alive!**

Absolute Advantage

- **Smith disagreed that trade was a zero sum game**
 - He was the first to show that a reallocation of resources and effort would produce a larger quantity of goods produced.
- **When Country A is absolutely better at producing a good or service than Country B, then it has an “absolute” advantage**
- **Key assumptions**
 - Countries have different capabilities to produce more of a product with the same amount of input
 - There is an absolute advantage balance among countries
- **Produce only goods where you are the most efficient and trade for those where you are not efficient**



Ricardo's Difficult Idea



- **When Country A is relatively more efficient at producing a good or service than Country B, then it has a comparative advantage**
- **Main insights**
 - Trade is determined by opportunity (not absolute) costs
 - Countries should specialize in the production of goods and services where they have a comparative advantage
 - Specialization raises world output and increases consumption levels—**trade is a positive sum game**

Other Trade Theories

- **Hecksher-Ohlin—differences in factor endowments**
 - where Ricardo showed that comparative advantage determines trade, H-O shows us that relative factor endowments determine comparative advantage since they determine opportunity costs.
- **Product Life-Cycle—trade patterns due to where a new product is introduced**
- **Porter Competitive Advantage—nation's competitive advantage is created not inherited.**
- **New trade theories (deal with the observation of imperfect competition)**
 - Based on substantial economies of scale that accompany specialization; only a few firms dominate
 - Notion of “first mover advantage” for early entrants which becomes a barrier to entry
 - Stress importance of technology, innovation
 - Implies gov't intervention—”strategic trade policy”

Krugman's Clarity

- Main purpose of trade is imports, not exports
- Objective of increasing productivity is to enable a country to produce more
- Emphasis on “high-value” sectors is misplaced; countries that don’t produce high value goods benefit from trade
- Trade policy has no effect on net job creation (the natural rate of unemployment is relatively unchanged over time); rather trade policy causes reallocations but not a net long-term change in employment.
- Wages do not fall if workers compete globally for “scarce” jobs; wages are dependent on productivity



Shifting Focus in Trade Theory

- **Limits of neo-classical theory**
- **From country to firm**
- **From perfect to imperfect competition**
- **Focus on innovation and technology**
- **Yet, neo-classical theory best supported by evidence**

